Czech Economic Quarterly

December 19, 2022

The winter of strong headwinds

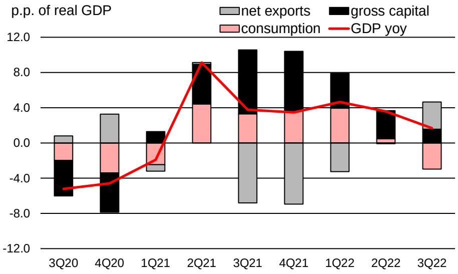
- In 3Q22, real GDP shrank by (SA) 0.2% qoq, slowing the yoy growth to 1.7%. Consumption contracted by 5.9% yoy, while government spending was down by 1.2% yoy. By contrast, fixed capital formation expanded by 4.6% and inventories continued in their acummulation, contributing to GDP growth by 0.4pp. Net exports pushed up GDP growth by 3.1pp on export and import dynamics improving to 10.5% and 6.2% yoy, respectively.
- We see a little chance for a rebound of GDP in 4Q22. The latest manufacturing PMI (at 41.6) displays deep pessimism, while surveys of households' Christmas spending intentions are not positive either. We expect 4Q22 GDP at -0.8% qoq and +0.1% yoy.
- GDP is seen to trough in 1Q23 but post a full-2023 decline of 0.6%. Private spending will be hit by an expected 3% drop in real wages. The recession will drag capital spending. On a more positive note, the depressed household consumption should put a cap on demand-push inflationary factors in 2023. Despite that, the passthrough of energy prices to CPI and some legacy issues may keep inflation at close to 10% until the end of 2023.
- We find further rate hikes rather unlikely. That said, with inflation showing much persistence, we have become less confident about an extent of rate cuts in 2023. We still believe the easing process will start in late-2023 but the repo rate may not decrease below 6% by the end of the year.

REAL GDP (CONSTANT PRICES OF 2010, ADJUSTED)

	3Q22		2Q22 revised	
	YoY change	% of change in GDP*	YoY change	% of change in GDP*
GDP total	**1.7**	**1.7**	**3.6**	**3.6**
Household consumption (%)	-5.9	-2.7	8.2	0.1
Government consumption (%)	-1.2	-0.2	2.2	0.4
Fixed capital formation (%)	4.6	1.2	6.9	1.7
Change in inventories	-	0.4	-	1.5
Net exports	-	3.1	-	-0.1

Source: Czech Statistical Office. Calculations: UCB CZ.
**/ Real GDP in the same period of previous year*
Remark: The national accounts are based on chain-linked data, which introduces a discrepancy between GDP and real demand components.

Breakdown of GDP growth by demand*



*/ Contributions to real GDP growth in percentage points
Sources: CZSO, UniCredit Research.

3Q22 saw an extension of changes in the structure of GDP, started in 2Q22. Consumption proved a drag on GDP growth, as both private and government spending fell. Gross capital performed better but its contribution to GDP halved from 2Q22. Net exports, by contrast, displayed the first positive input to growth since 4Q20.

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3Q22: IMPLOSION OF CONSUMPTION

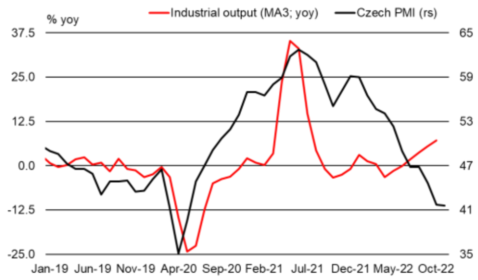
In 3Q22, real GDP shrank by (SA) 0.2% qoq, slowing the yoy growth to 1.7%. Consumption almost imploded, as private spending contracted by 5.9% yoy and government spending was down by 1.2% yoy. By contrast, fixed capital formation expanded by 4.6% yoy on a rise in all types of investment but dwellings, slowing only moderately from 6.7% yoy in the previous quarter. Inventories continued in their acummulation for the seventh quarter running, contributing to GDP growth this time by 0.4pp. Exports picked up on an improved performance in automotive, rising by 10.5% yoy, whereas an import dynamic remained weaker at 6.2% yoy. Net exports thus pushed up GDP growth by 3.1pp in its highest contribution since 4Q20. Nominal GDP further accelerated to 11.6% yoy, as GDP deflator printed 9.8% yoy in another high since 1998. From the production side, information&communication (+4.6% yoy) and manufacturing (+3.2% yoy) displyed the fastest real growth of gross value added, whereas transport&trade (-1.7% yoy) and construction (-0.7% yoy) saw a contraction. Total employment came higher by 1.8% yoy and hours worked added 2.0% yoy, both indicators presumably lifted by refugees from Ukraine. Thus, the labor productivity fell marginally in both the per-worker and the per-hour metric. What helped save the economy from a loss of competitiveness was slower growth of employee compensation (6.4% yoy) against nominal GDP. This resulted in a 9.8% yoy decrease of real wages for the second quarter in a row, an unprecedented drag on the households' purchasing power.

Czechia has remained one of a few EU countries with GDP not yet returning to a pre-covid level. One reason for the GDP missing the 4Q19 level by 0.5% is depressed tourism. In 3Q22, foreign visitor spending inside the country net of spending of Czechs abroad, although improving from 2020-2021, stayed by a third below pre-covid years. Even worse, the balance was bolstered by the lowest spending of Czechs abroad since 2005 (with only the covid-affected 2020 summer comparable). The missing third, if annualized, would represents 1.2% of GDP. The imploding overall household consumption suggests that Czechs did not replace lower spending abroad with higher spending on tourism inside the country.

4Q22: RECESSION TO DEEPEN

We see a little chance for a rebound in GDP from 3Q22. In October, industrial output slowed to 3.1% yoy (adjusted). The automotive industry, which was lifting the index the most until recently, is set to lose momentum, as the number of cars produced reversed to a yoy decline in November. November manufacturing PMI (at 41.6) displayed deep pessimism. In addition, some companies might have frontloaded production before the end of 2022 to take advantage of still lower energy prices. Retail sales (ex-auto, WDA) slumped by 9.4% yoy in October, as inflation continued to eat up into households' purchasing power. For November, we project retail sales at -7% yoy in not much of an improvement, although sales in restaurants went probably up yoy. Surveys of households' Christmas spending intentions are not positive either. We expect 4Q22 GDP at -0.8% qoq and +0.1% yoy.

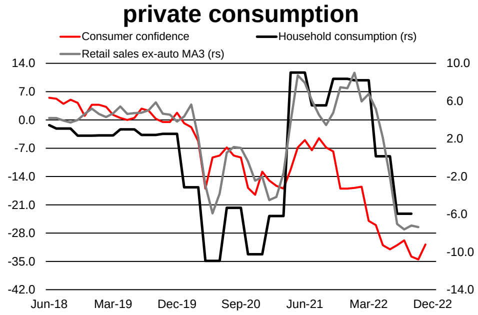
Manufacturing PMI and industrial output



Sources: CZSO, Markit, UniCredit Research.

Supply-side issues during the Covid-19 era blurred the link between Czech manufacturing PMI and industrial output growth. As the demand side starts playing a more important role to producers again, normalization of the link may be soon restored. Deep pessimism mirrored in PMI is expected to translate into an output loss in early 2023.

Consumer confidence, retail sales and private consumption



Sources: CZSO, UniCredit Research.

Consumer confidence hit an all-time low lately, which has been traced by a slump in household consumption. Unlike 2020 when private spending experienced an even deeper contraction, the latest slump is caused by households cutting retail sales rather than services.

2023: GDP TO TROUGH IN 1Q23

Energy prices continue to be the crucial factor that drags down economic activity. Importantly, the government finally agreed on compensating high energy prices paid by large firms (see also Focus on page 4), significantly reducing the probability of black scenarios of sharp drop in manufacturing production in 2023, with spillovers to the rest of the economy. However, there is still a risk of a severe cost shock in the economy at the turn of the year when companies typically renegotiate their energy contracts.

As regards the household sector, we expect real wages to contract by 3% in the whole of 2023 but as much as 8% yoy in 1Q23. Theoretically, households may support their consumption from large precautionary savings accumulated during the Covid-19 pandemic, part of which has remained untapped. However, the ratio of household deposits to nominal consumption returned to a long-term rising trend in 2Q22, suggesting limited willingness of households to further deplete their savings. Separately, we forecast the unemployment rate to grow only moderately, having a limited negative impact on household demand. On balance, we expect private consumption to contract by 2.2% in 2023.

The recession will also affect capital spending, which is already impacted by rising borrowing costs. Fixed capital formation is projected to decline by 0.5% in 2023. Investment in energy-saving projects may have some positive effect but a reduced inflow of new construction orders will curb capital spending. Huge inventory accumulation will turn into a drag on growth in 2023 as financing the excessive stock of inputs becomes too expensive. Thus, gross capital formation is expected to fall by 8.8% in 2023.

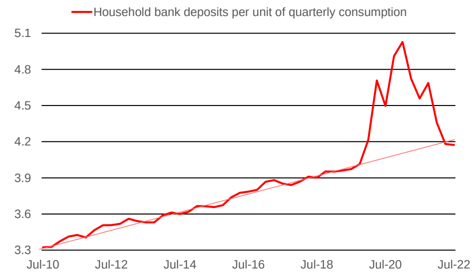
Net exports may in contrast contribute positively to GDP growth in 2023. First, the assumed reversal in the inventory cycle and lower consumption could reduce imports. Second, we expect the automotive industry to remain resilient as waiting lists for some car models are still long. Risks still include persistent supply-chain bottlenecks as well as weaker foreign demand. The latter factor means that the positive contribution from net exports to overall GDP dynamic, estimated at 2.8pp for full-2023, may be rather modest in 1Q23 and will grow over time.

The recession should put a cap on demand-push inflationary factors. At the same time, lower commodity prices should gradually ease pressures from the cost side. Sharp growth in rental prices seems to reach its limit as well, with a potential to decelerate in 2023. All of this should lead to a gradual disinflation from the start of 2023. However, the passthrough of energy prices to CPI and some legacy issues may keep inflation at close to 10% until the end of 2023.

MONETARY POLICY: EASING TO START BY LATE-2023

The inflation easing from early 2023 is seen strengthening doves in the ČNB board, making further rate hikes rather unlikely. That said, with inflation showing persistence in 2023, we have become less confident about an extent of rate cuts. We still believe the easing process will start in late-2023 but the repo rate may not decrease below 6% by the end of

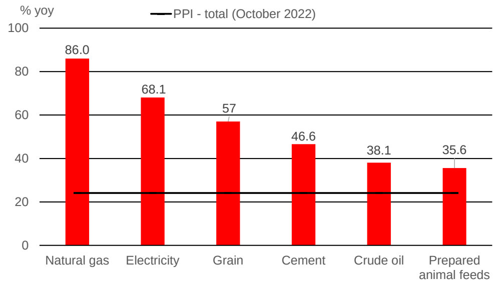
Household deposits and consumption



Sources: ČNB, Macrobond, UniCredit Research.

Bank savings of households have been growing faster than their consumption over many years, despite low interest rates. However, extreme increments of savings, recorded in 2020, were probably depleted by mid-2022, leaving households no extra cushion to overcome the current spell of a real income contraction.

PPI groups with the highest growth



Sources: CZSO, UniCredit Research.

In the list of PPI upside drivers, crude oil has retreated somewhat, leaving more space to natural gas and electricity. Within food items, grain has come to the fore, also affecting prepared animal feeds. Prices of cement, as an energy-intensive product, grew by almost half yoy.

the year. In terms of FX, we believe no more that the ČNB would formally declare the end of its intervention policy. Rather, the bank may allow some controlled CZK depreciation, selling fewer FX reserves in the process. We predict EUR-CZK to close 2023 at 25.20.

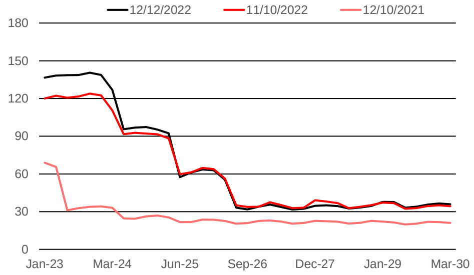
FOCUS: HOW COSTLY WILL THE ENERGY PRICE CEILINGS BE FOR THE CZECH GOVERNMENT?

In October, the government approved measures to help households, the public sector and small and medium-sized companies fight excessive prices of energies. From the start of 2023, the price ceilings will apply - for electricity at CZK 5,000 per MWh and for gas at CZK 2,500 per MWh (both without VAT). For companies, volumes of energies under the ceiling will be capped at 80% of their maximum consumption over last five years. In December, the government announced the same structure of deal also for large companies. This was preceded by a necessary notification of the policy with the European Commission. The principle needs to be maintained that for no company the overall state subsidy will exceed EUR 4 million.

How costly will the policy be for the state budget in 2023? To make a rough forecast, we need to estimate three parameters: consumption of gas and electricity; in each of the two sources the share to be capped at 80% of consumption; and average market price for each of the two sources. Of the three parameters, estimating the first one is prone the least to an error. In Czechia, net annual consumption may reach 70 terawatt hours (TWh) of gas and 60 TWh of electricity. Regarding the second parameter, we derived from the 2020 data that 43% of gas was consumed by businesses, which is the share to be capped. For electricity, we see in the 2020 data that 50% of consumption was distributed through high-voltage networks and hence, these 50% are probably set for capping. For the third parameter - average prices - we are looking at forward contracts. Forwards currently point to 140 EUR/MWh for gas and 350 EUR/MWh for electricity on average in 2023.

Putting the three estimated parameters together, we conclude that each TWh of gas consumed may cost the government EUR 40 million, or (assuming EUR-CZK average rate at 25.0) CZK 1 billion. This brings an uncapped cost at CZK 70 billion and a capped one roughly at CZK 64 billion. For electricity, the state budget burden for one TWh is estimated at EUR 150 million, or CZK 3.75 billion. This would make the uncapped cost at CZK 225 billion, with the cap bringing it down to CZK 202 billion. Importantly, our forecast for both energy sources combined (CZK 266 billion) exceeds the amount of CZK 170 billion, stated by the government as the upper limit. Obviously, a number of caveats can be found in our (as well as government) forecasts. For example, price forwards vary each day and may not precisely match actual prices in future. We also note to be dealing only with the expenditure side of the state budget. The government hopes to raise sources for the policy by taxing excessive profits and power production. We are unable to make a credible forecast for those incomes. The fact nevertheless remains that they are unlikely to be high enough to bring the policy in the entire balance.

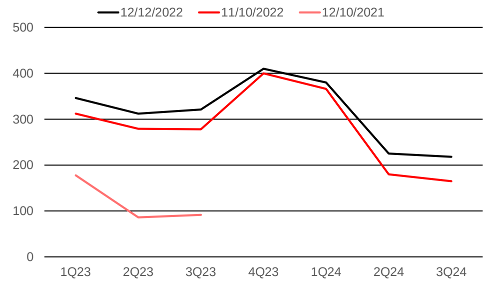
Forward prices of gas in Central Europe



Sources: UniCredit Research, Macrobond.

The latest forward curve for natural gas suggests that the price will stay elevated until 2026, although decreasing step by step. A year ago, the same forward curve pointed to much price stress easing already in 2023 and a terminal price level staying lower over following years. Hope remains that forwards are an imprecise indicator of future prices.

Forward prices of electricity in CE



Sources: UniCredit Research, Macrobond.

Baseload electricity forward prices make a peak next winter before starting to ease. The peak appears to be higher than derived from natural gas forwards, suggesting that a substantial risk premium remains built in. Likewise with gas, hope remains that forwards are an imprecise indicator of future prices.

Czechia Macroeconomic Outlook

	2020	2021	2022 forecast	2023 forecast	2024 forecast
GDP growth (real yoy change, %)	-6.4	3.5	2.5	-0.6	2.7
Household consumption (real yoy change, %)	-7.2	4.0	-0.8	-2.2	3.0
Gross fixed capital formation (real yoy change, %)	-6.0	0.6	5.2	-0.5	2.5
Industrial output (real yoy change, %)	-7.2	6.9	1.6	-2.0	4.0
Unemployment rate (average, %)	3.6	3.8	3.4	4.3	3.9
Inflation rate (CPI yoy change, average, %)	3.2	3.8	15.0	11.3	4.6
Average wages (nominal yoy change, %)	4.6	4.8	6.5	8.0	7.5
Interest rates (3-M PRIBOR, end of period, %)	0.35	3.50	7.25	6.15	4.40
Interest rates (3-M PRIBOR, average, %)	0.86	1.13	6.28	6.95	5.25
EUR/CZK exchange rate (end of period)	26.25	24.86	24.40	25.20	25.20
EUR/CZK exchange rate (average)	26.44	25.65	24.58	24.80	25.20
Current account balance (% of GDP)	2.0	-0.8	-5.6	-3.1	-1.7
FDI net inflow (% of GDP)	2.6	0.1	1.0	0.8	1.0
General government balance (% of GDP)*	-5.8	-5.1	-5.0	-5.0	-3.5
Public debt (% of GDP)	37.7	42.0	43.0	44.8	45.1

Remarks:
**/ ESA 2010 definition.*
Sources: Czech National Bank, Czech Statistical Office.
Forecasts: UniCredit Bank CZ.